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Blessings of Low Taxes Remain Unproved

By EDUARDO PORTER

The proposition that low tax rates produce higher economic growth has been a central plank of the Republican platform since I was a teenager.

In 1980, “The Blues Brothers” were making the jump from “Saturday Night Live” to cult status on the silver screen when Representative Jack F. Kemp of New York, an economic adviser to President-elect Ronald Reagan, warned that taxes were “strangling the ability of the private sector and the American people to grow and expand and invest and save.” He laid out a plan to cut taxes, pare loopholes in the tax code and curb federal spending.

In 1996 Steve Forbes, the magazine publisher, donned the low-tax mantle just in time for Yahoo’s I.P.O. and La Macarena. Running for the Republican nomination on the promise of a “pro-growth, pro-family tax cut,” he cornered the eventual nominee, Robert Dole, into promising cuts of his own.

Since then, we have had a dot-com bubble and a housing bust. The new standard-bearer for lower tax rates, Representative Paul Ryan of Wisconsin, is for the first time younger than I am.

But while the message has not changed, the track record of the last three decades does not bear out the core proposition of Republican economic doctrine.

The argument has proved extraordinarily successful. Under Republican presidents, the top income tax rate fell as low as 28 percent, less than half the 70 percent level it was in 1980.

The top corporate income tax rate was 46 percent when President Reagan took office. Today it is 35 percent. Taxes on investment income, which primarily flows to the wealthy, are even lower. In laying out his plan for a balanced budget by 2023, Mr. Ryan has trotted out the same three elements of Mr. Kemp’s formula: drastic curbs on spending, paring loopholes in unspecified ways and cutting tax rates even further, well below the roughly 40 percent top rate on income that was reintroduced by President Obama’s recent tax increase.

“The goal of tax reform should be to curb or eliminate loopholes and use those savings to lower tax rates across the board — not to fund more wasteful government spending,” Mr. Ryan’s budget plan states. Echoing Mr. Forbes, he called the new Republican proposal “a pro-growth tax system that benefits families and businesses.”

Problem is, there is little evidence that tax cutting has worked as advertised.

Thomas L. Hungerford, an economist with the Congressional Research Service, got into trouble with Republicans last year when he published a study suggesting that the sharp drop in top tax rates since 1945 did little to lift economic growth but probably did contribute to soaring income inequality.

And there's no clear evidence that lower tax burdens have helped the United States grow faster than other advanced industrial nations with higher tax rates and much heavier tax burdens. Economic growth per person in the United States was a little faster than in France or Australia over the last 40 years. But it was a little slower than in Austria, Germany and the Netherlands, according to data from the Organization for Economic Cooperation and Development, a research organization for the world's richest countries.

While high taxes do have an effect on variables that affect growth, many other factors are much more significant and overshadow whatever taxes do.

In high-tax European countries as varied as Germany, France, Britain and Denmark, productivity — or output per worker, the most important measure of a nation's ability to generate wealth — grew faster than in the United States over the last 40 years. If income per person didn't grow much faster it's because people in those countries chose to devote much of their extra productivity to more leisure.

The average American worker spends 1,700 hours a year on the job, 100 fewer than in 1970. The average French worker, by contrast, works about 1,500 hours, 500 fewer than 40 years ago. Meanwhile, until the financial crisis struck, labor participation grew faster in the United States than in other rich countries, including Germany, Sweden and France.

Taxes probably played a role in this, most economists agree. Indeed, higher tax rates can reduce economic output because they change the decisions of workers, employers and investors. Income taxes reduce the rewards of work, potentially blunting the incentive to take a job. They can discourage paying for a costly higher education by reducing lucrative professions' take home pay.

Higher corporate taxes at home can encourage American businesses to invest money abroad rather than in the United States. Differential tax rates pull investments into low tax sectors of the economy at the expense of others that might be more productive. Broadening the tax base by eliminating preferences and exemptions — an objective that Democrats and Republicans say they share — would reduce some of these distortions.

The crucial question, however, is how big an effect taxes have, compared with the other forces affecting the economy. Edward C. Prescott, an economist at the Federal Reserve Bank of Minneapolis, has argued that higher income taxes account entirely for the difference in working hours between the United States and Europe.

A Harvard economist, Martin Feldstein, President Reagan's chief economic adviser in the early 1980s, agrees. "Lower marginal tax rates lead to more labor input in the economy," he pointed out. "More people working more hours, more effort, more productive occupations, etc."

But there are many other factors at play, including strict labor market regulations in Europe and generous pension systems that encourage earlier retirement.

What's more, it's only natural that many people, given the opportunity, would take longer vacations as they became richer. As Olivier Blanchard, chief economist at the International Monetary Fund, told me: "There is plenty of evidence that Europeans like leisure, and leisure has become much more attractive."

Even Glenn Hubbard of Columbia, who as President George W. Bush's chief economic adviser helped shape the tax cuts that were partially reversed for the rich in January, noted: "It's always hard to know what to make of correlations between tax shares in G.D.P. (or tax rates) and growth, as so many factors influence both."

Recent history may even suggest the economy thrives when taxes are higher. Despite President Bush's tax cuts, the economy during his administration grew only about 17 percent, half as much as during that of his predecessor, Bill Clinton, who had raised them.

In 1996, the economists Jonathan Skinner of Dartmouth College and Eric M. Engen of the Federal Reserve Board tested Mr. Kemp's and Mr. Forbes's claims about the impact of taxes on growth. They concluded that a tax cut that reduced top rates by 5 percent and revenues by 2.5 percent of gross domestic product would add roughly 0.2 to 0.3 percent to annual economic growth.

They could not tell whether this effect would persist forever or peter out after 10 to 15 years. In any event, Mr. Skinner told me, the effect would be tiny relative to other factors, like education, regulatory policies and the quality of infrastructure.

This raises an additional point. Government spending — on things like education, infrastructure and basic research — can contribute to growth, too. "Higher taxes that finance good projects help growth," said Peter Diamond, a Nobel laureate at the Massachusetts Institute of Technology. The nation's dilapidated infrastructure and its slippage down the international education rankings are testament to the costs of underfinancing these public goods.

As in the early 1980s, the economy today remains well below its capacity. And Republicans are again calling for lower tax rates as a tonic for faster growth. But if lower taxes do not deliver higher growth, why should the nation pursue them?

"It's hard to say for sure what our economic trajectory would have looked like with higher taxes," said Alan Auerbach, an expert on the economics of taxation at the University of California, Berkeley. "Some of the disappointment that our low taxes haven't had a more obvious impact comes from overblown claims of tax cut supporters."

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